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Fraud Prevalent in Reverse Merger Companies with Operations in China

by **M. Norman Goldberger and Laura Krabill**

Anyone responsible for financial decisions on behalf of investors should be aware of the alert issued on June 9, 2011, by the Securities and Exchange Commission (SEC). The Investor Alert warned investors of the risk of investing in foreign companies who enter the U.S. markets through reverse merger transactions. This alert appears to have been prompted by the significant numbers of China-based operating companies that have recently been suspended from trading by the SEC as a result of discoveries of false or misleading financial statements and the resignation of a number of auditing firms that have uncovered misrepresentations by company management and oftentimes the companies' Chinese bank branches. In fact, there have been more than 40 China-based companies that have stopped trading, been subject to securities fraud allegations from the SEC or private investors, and/or had auditors resign citing lack of confidence in or actual knowledge of misstatements by company management. For at least the past six months, the SEC has been engaged in a large-scale investigation of companies whose primary assets were Chinese operating companies that went public through a reverse merger.

The SEC therefore warned investors to “proceed with caution when considering whether to invest in reverse merger companies.” The SEC specifically noted that “there have been instances of fraud and other abuses involving reverse merger companies” and that “some of the foreign companies that access the U.S. markets through the reverse merger process have been using small U.S. auditing firms, some of which may not have the resources to meet its auditing obligations when all or substantially all of the private company's operations are in another country,” thus inhibiting the auditing firms from “identify[ing] circumstances where these companies may not be complying with the relevant accounting standards.” The SEC therefore suggested that “individual investors should take into account their own financial situation, consult their financial adviser, and perform thorough research before making any investment decisions concerning these types of companies.” In particular, the SEC alert suggests: (1) researching the company; (2) reviewing its SEC filings; (3) being particularly wary of companies that do not file or that make available information about the public “shell” only, not about the private operating company that merged with it; and (4) being skeptical of tips or information on blogs, social networking sites, and “even a company's own website” since it “may be inaccurate and sometimes intentionally misleading.”

If a company's SEC filings and website are unreliable, how can an investor or adviser properly assess the risks of investing? The only way to really perform due diligence on these companies is to conduct investigations where the assets and operations exist — in China. Obviously, that is not realistic

for most investors, but presumably some of the parties who were involved in the reverse merger transaction did conduct that due diligence. Investors should consider the parties who were involved in the reverse merger (investment bankers, auditors, etc.) and ask for detailed information about the due diligence that was conducted. Investors can also do independent investigations on key transactions that are touted by the company on the Internet and through phone calls to the companies' purported customers or vendors.

Other inquiries that can lead to more or less comfort in investing include:

1. Where are the company's assets? Does it have offices or manufacturing facilities in the United States that may be executed against in case of fraud?
2. Where are the company's officers and members of its board of directors? Are there U.S. residents in upper management or on the board who could be subject to prosecution and civil liability if the company's filings are false?
3. Does the company have director and officer liability insurance? If so, what is the retention (deductible) and what are the limits? Who issued the policy?
4. Who are the company's accountants and auditors? Are they large firms with sufficient resources to have conducted appropriate audits? Are the auditors one of the Big Four or a Chinese affiliate that has not been inspected, cannot provide documents under Chinese law, and may not be subject to litigation in the United States if the financial statements turn out to be false?

Investors should contact a company's investor relations group and ask for information that is not in the SEC filings. The company may refuse to disclose the information, but that can be as telling as the information itself. And, finally, if a company's financial reports seem too good to be true, they probably are, particularly for Chinese reverse merger companies.

In short, investors should not assume the same comfort level in financial statements and disclosures of Chinese reverse merger companies as they do other public companies. There have been enough instances of serious securities fraud in these companies (and enough instances where sophisticated investors have been damaged with no recourse) that the old adage "buyer beware" is particularly true.

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